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## TAX CONSIDERATIONS IN BUYING AND SELLING A CORPORATE BUSINESS

ROBERT H. MONYEK\* AND RICHARD L. KESSLER†

WITH the increasing frequency of combining corporate businesses in the United States, every attorney representing corporate clients must ultimately find himself representing one of the parties to a transaction whereby a corporate business changes hands. While the range of problems to be dealt with in such a situation is extremely broad, income tax considerations present one of the most significant opportunities for the attorney to be of great assistance to his client. With careful analysis of the many possible methods whereby the combination can be accomplished, the attorney can determine which approach yields the most favorable tax consequences and, assuming this to be compatible with the relevant business considerations, recommend that this method be employed. As will be seen, until the form to be followed has been established, any agreement between the parties on the purchase price is meaningless, since a disadvantageous tax result may leave your client in a worse position than would have resulted from a less satisfactory price in a more favorable type of transaction. Too often, businessmen reach tentative agreement on price without agreement on the form of the transaction. It is at this point that the attorney's task becomes especially difficult and important, as the tentative agreement on price must frequently yield to a price which is more appropriate in light of the income tax result of the form in which the transaction is eventually cast.

Unfortunately, those types of transactions more beneficial to the buyer's tax position are typically less beneficial to the seller's, and vice versa. It is therefore foolhardy to insist blindly upon the approach

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most attractive to your client, with no consideration of its effect on the other party, as the tax advantage to your client may be exceeded by the other party's tax disadvantage, with the result that the combined taxes are greater than would have resulted from another form of transaction. Good planning requires that counsel for both parties determine the method resulting in the optimum combined tax result, recommend this format to the principals, and assist them in reaching agreement on a price which will, after taxes, leave each party as close as possible to the position which makes the transaction acceptable.

It is our purpose in this article to describe the possible methods of carrying out a corporate combination, the relative merits and disadvantages of each method to buyer and to seller, and to illustrate the type of situation in which each method could most likely be more attractive than any other. We assume in every case that the purchaser wishes to conduct the business in corporate form, rather than as a partnership or sole proprietorship, as for many reasons, taxes generally included, this is almost always the case. In describing the results of a particular type of transaction, we shall confine our comments to tax considerations. The reader should not infer from the absence of non-tax considerations from this article an indication that they be ignored, since no plan which is not a sensible business transaction should ever be pursued merely for its supposed tax advantage. Since the scope of this article is limited to tax implications and since great importance should be placed on other implications, the reader should also consider these non-tax legal and business implications and evaluate these in connection with the desired tax result.<sup>1</sup>

While each of the several different types of transactions discussed herein produces a somewhat different combination of tax effects on the buyer and seller, the precise tax considerations affected by the choice of the transactions are few. If the importance of each consideration is understood, the format producing the most desirable combined effect on all considerations can easily be determined by reviewing the different possible types of transactions to be discussed in this article.

From the seller's point of view, the tax considerations may include:

<sup>1</sup> For a checklist of non-tax as well as tax considerations see *Buyer's and Seller's Points in Sale of Corporate Business: An Outline Checklist*, N.Y.U. 21ST INST. ON FED. TAX, 1065 (1963).

1. If stock is sold, will the resulting gain or loss be recognized for tax purposes?
2. If the transaction takes the form of a sale of corporate assets—
  - a) Will gain or loss be recognized?
  - b) Will any portion of the recognized gain be ordinary income instead of capital gain?
  - c) Will any portion of investment credit claimed in prior years result in an addition to the tax for the year of sale?
  - d) If the corporation is subsequently liquidated, will the liquidation result in recognized income or loss to the shareholders?
3. What is the cost basis of any property other than cash received?

The buyer will generally want to consider:

1. If stock is purchased, will a subsequent liquidation of the corporation result in recognized income or loss to the shareholder (the buyer) or the corporation?
  - a) Will any portion of that gain be ordinary income?
  - b) Will any investment credit previously claimed be added to the tax for the year of liquidation?
2. What is the cost basis of assets acquired by purchase or upon liquidation of the purchased corporation?
3. What is the cost basis of the stock acquired?
4. Are net operating losses and other favorable tax characteristics of the seller corporation available to the buyer?

As previously indicated, there are many ways of buying and selling a corporate business and the tax effect varies with each method. In the discussion which follows, we shall explain the tax implications of several different methods of business combinations, including cash purchases of assets or of stock and tax-free reorganizations. If the facts of a given situation are measured against the tax effect of each method, the method producing the most favorable tax result in the case at hand can readily be determined.

## TAXABLE TRANSACTIONS

### SHAREHOLDERS SELL THEIR STOCK

One of the simplest methods of selling a corporate business would be for the shareholders to sell their stock to the purchasing corporation for cash. The selling shareholders will realize gain or loss<sup>2</sup> to the extent the amount realized exceeds their adjusted basis (normally cost),<sup>3</sup> although they may be able to defer the recognition of gain by electing

<sup>2</sup> INT. REV. CODE OF 1954, § 1001.

<sup>3</sup> INT. REV. CODE OF 1954, § 1012.

to report the gain on the installment basis where proceeds in the year of sale do not exceed 30% of the selling price.<sup>4</sup>

Since the corporation remains in existence exactly as before, no corporate tax can be created by the transaction.

The buyer may favor acquisition of stock where there are favorable tax attributes, such as net operating loss carryovers, in the corporation being acquired since these generally may be availed of by the buyer after the acquisition.<sup>5</sup> It may also be advantageous when the corporation has primarily high-basis low-value assets, since the basis remains unchanged, thereby ordinarily allowing greater depreciation deductions than would be possible if assets were purchased. If the reverse is true, and the corporation has high-value low-basis assets, an acquisition of stock would thus appear to be disadvantageous; however, as explained below, if the acquiring corporation obtains at least 80% of the stock of the selling corporation, it can generally establish a new basis for the assets, equal to their values, by meeting certain conditions of the Internal Revenue Code.<sup>6</sup>

### *Two-Year Liquidation*

This new basis for the assets can be achieved by liquidating the acquired corporation pursuant to a plan of liquidation adopted within two years following the purchase<sup>7</sup> of 80% of the stock, by reason of an Internal Revenue Code provision.<sup>8</sup> The effect of this provision is to treat the purchase of stock followed by a liquidation almost as if the transaction had been a purchase of assets in the first instance. This is accomplished by allocating to the assets, in proportion to their fair market values, the price paid by the acquiring corporation for the stock,<sup>9</sup> adjusted for transactions between the date of acquisition and the date of liquidation.<sup>10</sup> In a case where the stock is pur-

<sup>4</sup> INT. REV. CODE OF 1954, § 453(b).

<sup>5</sup> This is subject to the limitations of the INT. REV. CODE OF 1954, §§ 269, 382, described herein.

<sup>6</sup> Liquidation under INT. REV. CODE OF 1954, § 332, with basis determined under INT. REV. CODE OF 1954, § 334(b)(2).

<sup>7</sup> INT. REV. CODE OF 1954, § 334(b)(3), defines "purchased" which is generally considered to be any acquisition from an unrelated party in a taxable transaction.

<sup>8</sup> *Supra* note 6.      <sup>9</sup> Treas. Reg. § 1.334-1(c)(4)(vi)(b)(1958).

<sup>10</sup> These adjustments are enumerated in Treas. Reg. § 1.334-1(c)(4)(v)(1958) and provide that the stock must be increased by earnings and unsecured liabilities assumed by the parent and decreased by losses and distributions between the date the 80% ownership was acquired and the date of the last distribution in liquidation.

chased at a price in excess of the net basis of the corporation's assets, this will generally bring about greater depreciation deductions in future years than would have been allowable if the acquired corporation had remained in existence. Counsel must therefore ascertain whether the facts of the case at hand are such that it would be beneficial to liquidate in this manner. If the plan of liquidation is not adopted within the two-year period, or the applicable statutory provision is not satisfied in any other respect, the assets received in liquidation will have a basis equal to their basis to the acquired corporation,<sup>11</sup> so that no change in basis will result from the liquidation. Needless to say, if counsel wishes to take advantage of the opportunity to establish a new basis, he must be meticulous in complying with the terms of the statutory provision.

A liquidation giving rise to a new tax basis for the assets creates no recognized gain or loss to the parent corporation upon receipt of the liquidating distributions.<sup>12</sup> The liquidated corporation, however, will generally incur a tax liability as a result of the liquidation: (1) To the extent that the assets distributed in liquidation consist of depreciable personal property, the amount by which their values exceed their tax bases (but limited to the depreciation claimed thereon after December 31, 1961) is ordinary income to the liquidated corporation;<sup>13</sup> (2) Depreciable real property distributed in liquidation may also result in ordinary income to the liquidated corporation where depreciation in excess of straight-line has been claimed, to the extent of a percentage of the amount by which the depreciation claimed thereon since December 31, 1963, exceeded the depreciation that would have been claimed under the straight-line method of computing depreciation;<sup>14</sup> (3) To the extent that the liquidated corporation had in prior years claimed the 7% investment tax credit on acquisitions of property which, at the date of liquidation, had been held for a shorter period of time than was estimated as the property's useful life for purposes of computing the credit,<sup>15</sup> the excess credit thereby claimed in prior years

<sup>11</sup> INT. REV. CODE OF 1954, § 334(b) (1).

<sup>12</sup> INT. REV. CODE OF 1954, § 332(a).

<sup>13</sup> INT. REV. CODE OF 1954, § 1245, and Treas. Reg. § 1.1245-1(c) Example (2) (1965).

<sup>14</sup> INT. REV. CODE OF 1954, § 1250, and Example in Proposed Treas. Reg. § 1.1250-1(a)-(4), 31 Fed. Reg. 92 (1966).

<sup>15</sup> INT. REV. CODE OF 1954, § 47.

is added to, and becomes part of, the liquidated corporation's tax for the year of liquidation.

A liquidation giving rise to a new tax basis for the assets received will not entitle the parent corporation to avail itself of the net operating loss carryovers and other favorable tax attributes of the liquidated corporation.<sup>16</sup>

### *Advantages of Avoiding The Two-Year Liquidation*

If for any reason the code provision by which the assets received in liquidation acquire a new tax basis is not satisfied, so that they retain the same basis as in the hands of the liquidated corporation, this disadvantage is at least partially offset by a more favorable outcome under some of the other tax considerations discussed above. The tax on the liquidated corporation from income arising out of the distribution of depreciable property is eliminated, as the code provides for nonrecognition of this income in a liquidation on which the assets retain their bases.<sup>17</sup> Similarly, no investment credit claimed in prior years is added to the tax of the liquidated corporation if the assets retain their bases.<sup>18</sup> Finally, the parent corporation, after the liquidation, is entitled to take advantage of net operating loss carryovers and other favorable tax attributes of the liquidated corporation.<sup>19</sup>

In many instances, it will be better to purposely arrange a liquidation in such a manner that the assets do not take a new tax basis, as the tax benefit of the new basis may be less than the benefit of avoiding the additional tax on the liquidated corporation and causing the carryovers and other attributes to become available to the acquiring corporation. Counsel must carefully consider which procedure, all factors

<sup>16</sup> INT. REV. CODE OF 1954, § 381(a)(1).

<sup>17</sup> Where basis is determined under INT. REV. CODE OF 1954, § 334(b)(1), there is no depreciation recapture except for distributions to minority shareholders (INT. REV. CODE OF 1954, § 1245(b)(3) and § 1250(d)(3)), however, depreciation deductions of the subsidiary must be taken into account by the parent upon subsequent disposition (See Treas. Reg. § 1.1245-2(c)(2) (1965) and Proposed Treas. Reg. § 1.1250-4(c)(2), 31 Fed. Reg. 92 (1966)).

<sup>18</sup> There is no investment credit recapture according to INT. REV. CODE OF 1954, § 47(b)(2), since INT. REV. CODE OF 1954, § 381(a), applies where basis is determined under INT. REV. CODE OF 1954, § 334(b)(1). However, subsequent disposition of such property will result in recapture according to INT. REV. CODE OF 1954, § 381(c)(23).

<sup>19</sup> INT. REV. CODE OF 1954, § 381(a), does not exclude from the carryover provisions the general rule of INT. REV. CODE OF 1954, § 334(b)(1), in the liquidation of a subsidiary under INT. REV. CODE OF 1954, § 332.

considered, produces the best over-all tax result, and recommend to his client that this plan be followed.

#### CORPORATION SELLS ITS ASSETS

As an alternative to the sale of stock, the corporation could sell the corporate assets. The buyer may want to purchase assets when the seller's basis for the assets is lower than the price to be paid in order to obtain a higher basis, or where it is desirable to avoid taking over the seller's unfavorable tax attributes such as substantial accumulated earnings or an undesirable depreciation method. The sale of assets would be advantageous to the seller when the asset sale would create a net operating loss carryback to prior profitable years, thereby permitting seller to recover a portion of the taxes paid in prior years, or when it is desirable to keep the corporation in existence permanently so that the only tax paid will be the corporate tax on its gain, instead of the shareholder's tax on his presumably larger gain.

If the purchaser acquires the assets for cash, or for any other property in a taxable transaction, the basis of the assets is their cost.<sup>20</sup> No loss carryovers or other tax attributes of the selling corporation become available to the purchaser.

The tax effect on the selling corporation and its shareholders is dependent upon whether the corporation is liquidated, and the precise timing of any such liquidation. The different possibilities will be discussed and explained below.

#### *Twelve-Month Liquidation*

If the corporation adopts a plan of liquidation prior to the sale of assets and does in fact liquidate within twelve months after the adoption of the plan, the corporation (with one major exception, as indicated below)<sup>21</sup> recognizes no gains and losses from transactions during the twelve-month period.<sup>22</sup> The only tax paid is thus that imposed on the shareholders' gain on liquidation. The net effect to the shareholders is approximately the same as if they had sold to the purchaser their

<sup>20</sup> INT. REV. CODE OF 1954, § 1012.

<sup>21</sup> INT. REV. CODE OF 1954, §§ 1245, and 1250. See also INT. REV. CODE OF 1954, § 47.

<sup>22</sup> INT. REV. CODE OF 1954, § 337. But see INT. REV. CODE OF 1954, § 337(b), where gain will be recognized on non-bulk sales of inventory and certain dispositions of installment obligations.



stock in the corporation.<sup>23</sup> The only significant differences from the result of selling stock are that the corporation recognizes gain (notwithstanding the twelve-month liquidation provision) to the extent attributable to depreciation on personal property after 1961<sup>24</sup> and (subject to exceptions) to depreciation in excess of straight-line on buildings after 1963<sup>25</sup> and that the corporation's tax for the year of sale is increased by the investment credit claimed in prior years which has become excessive by reason of the short period of time for which the property which generated the credit was in fact held.<sup>26</sup> On a sale of stock, this tax would not have become due. However, if after a purchase of stock the purchaser had later liquidated the corporation in a transaction so arranged that the assets took a new basis, the tax generated by prior depreciation and investment credit claimed by the corporation would then be paid, in that case by the purchaser.<sup>27</sup> To this extent, the buyer benefits by buying assets instead of stock, and this difference in tax incidence must be kept in mind when negotiating the price and the form of the transaction.

The twelve-month liquidation provision is not elective and although it has the advantage of not recognizing gain, it also has the disadvantage of denying the recognition of losses. If there are substantial losses from the sale, the liquidation could be delayed until after the twelve months have elapsed.

Even if the buyer pays for the assets over a period of years, the installment method of reporting gain<sup>28</sup> will not be available if the corporation is liquidated, as the taxable incident to the stockholder is the corporate liquidation, not the sale. If an installment sale is contemplated, it is therefore often best to sell stock instead of assets.

<sup>23</sup> Where the corporation sells its assets and then liquidates under INT. REV. CODE OF 1954, § 337, amounts distributed to the shareholders will be treated as full payment in exchange for the stock under INT. REV. CODE OF 1954, § 331(a)(1), and the stockholders will be required to pay a capital gains tax on the difference between the cash plus fair market value of the liquidating distribution (Treas. Reg. § 1.1001-1(a) (1957)) and the basis of his stock.

<sup>24</sup> INT. REV. CODE OF 1954, § 1245.

<sup>25</sup> INT. REV. CODE OF 1954, § 1250.

<sup>26</sup> INT. REV. CODE OF 1954, § 47.

<sup>27</sup> INT. REV. CODE OF 1954, §§ 1245(a)(1), 1250(a)(1), and 47(a)(1).

<sup>28</sup> INT. REV. CODE OF 1954, § 453.

### *Deferring Liquidation*

If a sale of assets results in a substantial loss, so great that a portion of it remains available as a carryover to future years, it is generally best not to liquidate the corporation until after the loss carryover has all been applied against the income of future years or has expired.<sup>29</sup> If, however, the corporation is closely held and derives at least 60% of its income from investments (as distinguished from the active conduct of a business), it will have the status of a "personal holding company"<sup>30</sup> and be subject to a penalty tax of 70% on any income which it does not distribute as a dividend. In such an instance it is generally just as well to liquidate in the year following the sale, as under the personal holding company provisions loss carryovers are allowable in only the year immediately following the loss year.<sup>31</sup>

There is often a different reason for maintaining the corporate existence after it has sold its assets. The obvious reason is that if the corporation is kept in existence permanently, the shareholders will never pay tax on the amount by which the value of the corporation exceeds the basis of their stock. A liquidation would cause the shareholders to pay tax on their resulting gain, while the continued existence of the corporation may postpone permanently the payment of this tax.<sup>32</sup> Even though the continuing corporation may be a personal holding company, its existence will ordinarily not create an annual income tax liability for a tax on current income significantly greater than that which would be paid if the corporation had been liquidated. The corporation generally pays only a nominal tax<sup>33</sup> and the shareholder pays tax on its entire investment income, just as he would if the corporation had

<sup>29</sup> INT. REV. CODE OF 1954, § 172, provides for a three year carryback or a five year carryback of a net operating loss.

<sup>30</sup> See INT. REV. CODE OF 1954, §§ 541-547. Generally, the corporation will be a personal holding company if five or fewer individuals own more than 50% in value of the outstanding stock and at least 60% of its adjusted ordinary gross income (capital gains excluded) is from dividends, interest, royalties, annuities, and rents. Special rules for inclusion of rents and royalties are provided in INT. REV. CODE OF 1954, § 543(a)(2)-543(a)(4).

<sup>31</sup> INT. REV. CODE OF 1954, § 545(b)(4).

<sup>32</sup> Under present law, INT. REV. CODE OF 1954, § 1014 provides that the basis of property received from a decedent will generally be the fair market value of the property at the decedent's death. A Shareholder's stock may thus be redeemed at no tax cost after his death.

<sup>33</sup> As long as the corporation's investments are confined to stocks, its tax rate cannot exceed 7.2%. INT. REV. CODE OF 1954, § 243.

previously been liquidated and the shareholder received the investment income directly as the owner of the income-producing property. No personal holding company tax at the 70% rate will ever be paid as long as the corporation distributes its entire income as a dividend each year,<sup>34</sup> and counsel must be sure that his client pays sufficient dividends each year to accomplish this.

### NON-TAXABLE TRANSACTIONS

If the transfer of a corporation's business to another corporation takes the form of a tax-free reorganization,<sup>35</sup> the seller will obviously benefit from the nonrecognition of any gain resulting from the transfer.<sup>36</sup> If instead the transfer generates a loss, the reorganization approach has a disadvantage to the seller in that this loss will similarly not be recognized for tax purposes. As explained below, the seller in a reorganization transaction will be paid in stock of the acquiring corporation rather than in cash, and the tax cost basis of the stock will generally be the same as that of the assets or stock transferred,<sup>37</sup> so that upon a later disposition of the stock of the acquiring corporation the gain not now recognized will become taxable. Before a conclusion is reached that a reorganization is the best plan in a given situation, consideration must be given to the possibility that the gain deferred because the transaction qualified as a reorganization may become taxable at a later date, thereby nullifying what may have been one of the important reasons for choosing the reorganization approach initially. If this appears likely, it may be better to have a cash purchase instead of a reorganization, if the other effects of a reorganization, as discussed below, are less desirable than the outcome of a cash purchase.

Since the acquiring corporation would in no event have taxable income from the acquisition,<sup>38</sup> the tax-free nature of the reorganization is of no direct interest to it. Those consequences of a reorganization which are relevant from the buyer's point of view are that any assets (stock or other property) acquired in a reorganization retain the tax basis which they had in the hands of the prior owner,<sup>39</sup> and net operating losses and other favorable tax attributes generated by the trans-

<sup>34</sup> INT. REV. CODE OF 1954, § 541.

<sup>35</sup> INT. REV. CODE OF 1954, § 368(a)(1).

<sup>36</sup> INT. REV. CODE OF 1954, § 354.

<sup>38</sup> INT. REV. CODE OF 1954, § 1032.

<sup>37</sup> INT. REV. CODE OF 1954, § 362.

<sup>39</sup> *Supra* note 37.

feror corporation are available.<sup>40</sup> These effects, both of which differ from the result in a cash purchase, may cause the purchaser to be greatly benefited or harmed by the choice of a reorganization approach.

In order to qualify as a reorganization a transaction must be motivated by a legitimate business purpose<sup>41</sup> and must result in a continuity of interest to the selling corporation's shareholders.<sup>42</sup> These reorganizations, including the tax significance<sup>43</sup> and the advantages and disadvantages of each, will be the subject of the following discussion.

#### STOCK FOR STOCK

One of the methods of acquiring a business tax-free is to acquire 80% or more control<sup>44</sup> of the stock of the seller, solely in exchange for the acquiring corporation's voting stock. This method will be referred to hereinafter as a "stock for stock reorganization" and is sometimes referred to as a "B" reorganization.<sup>45</sup> The stock for stock reorganization permits the acquired corporation to continue taking advantage of its own loss carryovers and other favorable tax attributes. Since the acquired corporation remains in existence, no corporate tax is generated, whether from prior depreciation or investment credit or any other cause.

In a stock for stock reorganization, the buyer does not have to acquire the 80% or more control at one time and may even have owned

<sup>40</sup> INT. REV. CODE OF 1954, § 381.

<sup>41</sup> Treas. Reg. § 1.368-2(g) (1955).

<sup>42</sup> *Ibid.* See also *Comm'r v. Segall*, 114 F.2d 706 (6th Cir. 1940), *reversing* 38 B.T.A. 43 (1938), *cert. denied* 313 U.S. 562 (1940); *Roebbling v. Comm'r.*, 143 F.2d 810 (3d Cir. 1944), *affirming* 2 CCH Tax Ct. Mem. 392 (1943), *cert. denied* 323 U.S. 773 (1944).

<sup>43</sup> The operating provisions applicable to reorganizations are as follows: (1) INT. REV. CODE OF 1954, § 354, providing for non-recognition of gain or loss on the exchanges of stock or securities between parties to a reorganization as defined in INT. REV. CODE OF 1954, § 368(b); (2) INT. REV. CODE OF 1954, § 361, providing for non-recognition of gain or loss to corporation upon the exchange of property for stock or securities pursuant to a reorganization; (3) INT. REV. CODE OF 1954, §§ 356 and 357, providing for the treatment of "boot" and liabilities in reorganization exchanges; (4) INT. REV. CODE OF 1954, §§ 358 and 362(b), providing for carryover of basis in reorganization exchanges; and (5) INT. REV. CODE OF 1954, § 381, providing for certain carryover attributes subject to the net operating loss carryover limitation of INT. REV. CODE OF 1954, § 382(b).

<sup>44</sup> Control is defined in INT. REV. CODE OF 1954, § 368(c), as ownership of stock possessing at least 80% of the total combined voting power of all classes of voting stock and the ownership of at least 80% of the total number of shares of each class of outstanding non-voting stock. See Rev. Rul. 59-259, 1959-2 CUM. BULL. 115.

<sup>45</sup> INT. REV. CODE OF 1954, § 368(a)(1)(B).

for some time some stock acquired in a taxable transaction. In order for the transfer presently under consideration to be tax-free, it must be an exchange solely for the buyer's voting stock.<sup>46</sup> The term solely for voting stock means that the use of any additional consideration prevents the entire transaction from qualifying as a reorganization.<sup>47</sup>

In a stock for stock reorganization, the acquiring corporation's basis for the stock acquired would be the seller's basis<sup>48</sup> and the holding period will include the holding period of the seller.<sup>49</sup> The seller's basis for the stock of the acquiring corporation is the basis of its stock given in exchange<sup>50</sup> and the holding period will include the holding period of the old stock.<sup>51</sup>

#### STOCK FOR ASSETS

The other methods of acquiring a business tax-free both involve a corporation's acquisition of the assets of another corporation in exchange for its own stock. The requirements of and differences between the two methods of accomplishing this will be discussed below. Since there are many similarities between the results of the two plans, and therefore between the types of situations in which each will be attractive, it is appropriate to consider first what they have in common.

Any tax-free asset for stock transaction entitles the acquiring corporation to take advantage of any loss carryovers or other favorable tax attributes of the transferor corporation.<sup>52</sup> The transfer of assets is completely tax-free to the transferor corporation (except to the extent that part of the consideration is not stock or securities eligible for tax-

<sup>46</sup> Treas. Reg. § 1.368-2(c) (1955). However, where part of the stock is acquired for cash and soon thereafter controlling stock is acquired in an attempt to qualify as a "B" reorganization, the step transaction theory may be applied to treat the two acquisitions as one and the second acquisition would be taxable as the transaction was not solely for stock. See Rev. Rul. 59-259, *supra* note 44.

<sup>47</sup> *Turnbow v. Comm'r.*, 368 U.S. 337 (1962), *affirming* 286 F.2d 669 (9th Cir. 1961), *reversing* 32 T.C. 646 (1959). But see, *Mills v. Comm'r.*, 331 F.2d 321 (5th Cir. 1964) *rev'g.* 39 T.C. 393 (1962).

<sup>48</sup> INT. REV. CODE OF 1954, § 362(b).

<sup>49</sup> INT. REV. CODE OF 1954, § 1223(1) and § 1223(2).

<sup>50</sup> INT. REV. CODE OF 1954, § 358(a).

<sup>51</sup> INT. REV. CODE OF 1954, § 1223(1), if such stock was a capital asset in their hands.

<sup>52</sup> INT. REV. CODE OF 1954, § 381(c), enumerates the items which are carried over and Treas. Reg. § 1.381(a)-1(a) to § 1.381(a)-1(b) make such provisions applicable to an (A) and (C) reorganization as defined in INT. REV. CODE OF 1954, § 368(a)(1).

free treatment under the particular section)<sup>53</sup> even to the extent of gain resulting from prior depreciation,<sup>54</sup> and no tax results from the transfer of property on which investment credit has previously been claimed.<sup>55</sup> The tax basis to the transferee corporation of the assets received is the same as their basis to the transferor corporation,<sup>56</sup> and the basis of stock received from the acquiring corporation is the same as the basis of the property surrendered in exchange therefor.<sup>57</sup>

### *Merger or Consolidation*

One method of accomplishing a tax-free stock for asset reorganization is the statutory merger or consolidation (sometimes referred to as an "A" reorganization)<sup>58</sup> consummated pursuant to the corporation laws of the United States, a state or territory, or the District of Columbia.

This approach permits more flexibility than the stock for stock reorganization in the choice of the type of securities to be transferred in exchange for the assets. Under the statutory merger or consolidation plan, nonvoting common stock, preferred stock, or other securities of the acquiring corporation may be transferred, without causing the transaction to lose its tax-free status. If cash or other property is transferred in addition to stock and securities of the acquiring corporation, the transaction will be taxable only to the extent of the cash or other property,<sup>59</sup> rather than in its entirety as under the stock for stock reorganization.<sup>60</sup>

<sup>53</sup> INT. REV. CODE OF 1954, § 356.

<sup>54</sup> Gain on depreciation recapture will be recognized, but only to the extent that gain would otherwise be recognized (to the extent of "boot" under INT. REV. CODE OF 1954, § 356) on the transfer of such assets. (INT. REV. CODE OF 1954, § 1245(h)(3), and § 1250(d)(3); Treas. Reg. § 1.1245-4(c) (1955) and Proposed Treas. Reg. § 1.1250-3(c), 31 Fed. Reg. 92 (1966).) Depreciation deductions of the seller on the property transferred which exceed the depreciation recapture recognized on the transfer of such assets must be taken into account by the buyer upon subsequent disposition according to Treas. Reg. § 1.1245-2(c)(2) (1965) and Proposed Treas. Reg. § 1.1250-3(c)(3), 31 Fed. Reg. 92 (1966).

<sup>55</sup> INT. REV. CODE OF 1954, § 47(b)(2).

<sup>56</sup> *Supra* note 37.

<sup>57</sup> INT. REV. CODE OF 1954, § 358(a). The basis of the property acquired is the same as the basis of the property exchanged reduced by any "boot" under INT. REV. CODE OF 1954, § 356, and increased by any gain recognized. "Boot" has a basis of fair market value under INT. REV. CODE OF 1954, § 358(a)(2).

<sup>58</sup> INT. REV. CODE OF 1954, § 368(a)(1)(A).

<sup>59</sup> INT. REV. CODE OF 1954, § 356.

<sup>60</sup> *Supra* note 47.

A merger of two or more corporations takes place when one of the corporations retains its corporate existence and absorbs the other or others, which thereby lose their corporate existence. A consolidation is a combination of two or more corporations by the formation of a new corporation into which the old corporations are dissolved. In either case, stock of the continuing corporation is issued to the former shareholders of the absorbed corporations.

In addition to meeting the requirements of the applicable state statute, the transaction must perpetuate the taxpayer's original investment (referred to as continuity of interest)<sup>61</sup> and be motivated by a legitimate business purpose.<sup>62</sup> A transfer for cash, promissory notes and debentures may constitute a statutory merger or consolidation for purposes of state law, but if it fails to preserve the investor's proprietary interest in the enterprise, it does not qualify as a reorganization.<sup>63</sup> The same is true if common stock forming part of the consideration has a value representing only a small fraction of the total consideration paid.<sup>64</sup>

A statutory merger or consolidation need not meet the "solely for voting stock" requirement of the stock for stock reorganization, and the acquiring corporation may therefore issue stock or securities other than its common stock in exchange for the properties of the merged corporations.<sup>65</sup> Furthermore, a nonvoting common or preferred stock may be utilized and the exchange can qualify as a merger or consolidation even if money or other property changes hands. The money or property (and securities in some circumstances) will constitute "boot,"<sup>66</sup> taxable to the recipients, but will not result in disqualifying the transaction in its entirety, as can occur when money, property or securities are used in a stock for stock reorganization. This allows the seller's common voting stock equity to be converted into a nonvoting or preferred stock equity, or into a combination of both voting and nonvoting not possible under other reorganization provisions.

<sup>61</sup> *Morgan Manufacturing Co.*, 124 F.2d 602 (4th Cir. 1942), *affirming* 44 B.T.A. 691 (1941).

<sup>62</sup> Treas. Reg. § 1.368-2(g) (1955).

<sup>63</sup> *Supra* note 42.

<sup>64</sup> *Southwest Natural Gas Co. v. Comm'r.*, 189 F.2d 332 (5th Cir. 1951), *affirming* 14 T.C. 81 (1950), *cert. denied* 342 U.S. 860 (1951), where the stock represented less than one per cent of total consideration received by the old shareholders.

<sup>65</sup> See *National Gypsum Co. v. Comm'r.*, 1 CCH Tax Ct. Mem. 349 (1942), Rev. Rul. 54-396, 1954-2 CUM. BULL. 147.

<sup>66</sup> INT. REV. CODE OF 1954, § 354(a) (1) and § 356.

The basis of the stock or securities received as a result of a statutory merger or consolidation is the same as the basis for the stock or securities surrendered, increased by the amount of any gain recognized on the transaction and decreased by the amount of any cash received.<sup>67</sup>

### *Stock for Assets Reorganization*

The second nontaxable method of acquiring assets for stock is what is sometimes referred to as a "C" reorganization.<sup>68</sup> The tax effect of this transaction is virtually identical to that of the merger or consolidation, except that here the consideration must (with limited exception) consist solely of voting stock.

This type of reorganization occurs when one corporation acquires substantially all the properties of another corporation, solely in exchange for all or a part of its voting stock.<sup>69</sup> In determining whether the exchange meets the requirement of "solely for voting stock," the assumption by the acquiring corporation of liabilities of the transferor corporation will be disregarded.<sup>70</sup> If substantially all the property is acquired, and at least 80% of the fair market value of all the property is acquired solely for voting stock, the remainder of this property may be acquired for cash or other property without completely disqualifying the transaction as a reorganization.<sup>71</sup> However, gain will be recognized by the transferor to the extent of the cash or other property.<sup>72</sup>

The term "substantially all" is not precisely defined in the Internal Revenue Code or the related Regulations, and as a result, is subject to judicial interpretation. In determining what constitutes "substantially all," the Internal Revenue Service will consider the amount and the nature of the properties retained by the transferor and the purpose of the retention, rather than any particular percentage of the properties held.<sup>73</sup> Generally, however, even though no particular percentage is controlling, it would appear that 90% or more of the assets would be

<sup>67</sup> INT. REV. CODE OF 1954, §§ 358(a) and 362.

<sup>68</sup> INT. REV. CODE OF 1954, § 368(a) (1) (C).

<sup>69</sup> *Ibid.*

<sup>70</sup> Treas. Reg. 1.368 (1955).

<sup>71</sup> INT. REV. CODE OF 1954, § 368(a) (2) (B) (iii).

<sup>72</sup> *Supra* note 59.

<sup>73</sup> Rev. Rul. 57-518, 1957-2 CUM. BULL. 253: Only 70% of the assets was sufficient where 3% of its inventory and enough cash, accounts and notes receivable were retained to pay its outstanding liabilities before liquidating.



considered "substantially all"<sup>74</sup> but that less than 80% may not be considered substantially all.<sup>75</sup> In order to obtain an advance ruling from the Internal Revenue Service that the transaction qualifies as a "C" reorganization, it must be shown that there will be a transfer of at least 90% of the fair market value of the net assets, and at least 70% of the fair market value of the gross assets held by the corporation immediately before the transfer.<sup>76</sup>

After a corporation has transferred substantially all of its assets to another in exchange for voting stock, the transferor is left with virtually no property other than the stock of the transferee. Keeping this corporation in existence as an investment company would generally serve no useful purpose, and since it can be liquidated in a transaction creating no gain or loss to the shareholders or the corporation,<sup>77</sup> the customary practice is to liquidate it shortly after the exchange of stock for property. After this liquidation, the shareholders of the liquidated corporation own the stock acquired in exchange for the property of the corporation. The end effect is thus identical with that which would have resulted from a merger, in which the corporation's existence would have terminated simultaneously with the transfer of assets.

### *Limitations of Carryovers and Attributes*

In several instances described above, reference has been made to the availability in the future of loss carryovers and other favorable tax attributes gathered by the acquired corporation in prior years. In certain instances, the Code restricts the availability of these attributes.<sup>78</sup> Prior to adopting any plan of acquisition, consideration should be given to these possible limitations.

The most definite limitation applies in every instance in which after a reorganization taking the form of a transfer of assets (an "A" or "C")

<sup>74</sup> *Brett v. Comm'r.*, 114 F.2d 10 (4th Cir. 1940), *affirming* 40 B.T.A. 790 (92%), *Courtland Specialty Co. v. Comm'r.*, 60 F.2d 937 (2nd Cir. 1932), *affirming* 22 B.T.A. 808 (1931), *cert. denied* 288 U.S. 599 (1932) (91½%); *American Foundation Co. v. United States*, 120 F.2d 807 (9th Cir. 1941) (92.6%), *Nelson v. United States*, 69 F.Supp. 336 (Ct. Cl. 1947), *cert. denied* 331 U.S. 846 (1947) (91.6% and 95.7%).

<sup>75</sup> *Pillar Rock Packing Co. v. Comm'r.*, 90 F.2d 949 (9th Cir. 1937) (66%); I.T. 2373, VI-2 CUM. BULL. 19 (68% or 75%), but see Rev. Rul. 57-518, *supra* note 73 (70%).

<sup>76</sup> Rev. Proc. 66-34, 1966 INT. REV. BULL. No. 22.

<sup>77</sup> INT. REV. CODE OF 1954, § 354.

<sup>78</sup> The limitation or reduction of the net operating loss carryover is computed under INT. REV. CODE OF 1954, § 382(b)(2).

reorganization) the shareholders of the corporation which generated a loss carryover from prior years own less than 20% of the acquiring corporation.<sup>79</sup> In such a situation, the loss allowable in future years is reduced by 5% for every percentage point by which the ownership of the acquiring corporation is less than 20%.

Another provision of the Code, very general in its application, provides that whenever an acquisition was for the principal purpose of securing a tax benefit which would not otherwise have been available, the tax benefit will be disallowed.<sup>80</sup> Since we have assumed in our discussion above that the acquisition herein discussed was motivated by business considerations, this should not be a problem in the situation contemplated by our discussion.

### CONCLUSION

The attorney representing a party to a proposed transfer of a corporate business should review the plans discussed above, and determine which of them are feasible from a business point of view, ignoring taxes. The tax effects of each feasible plan on buyer and seller should then be computed, and each party's position under each plan should be compared with his position under each other plan. The plan which provides the best combined result for buyer and seller should then ordinarily be recommended by counsel, even though a different plan might be better for buyer or seller. In setting the purchase price, consideration should be given to how much tax advantage each party has given up by agreeing to the plan recommended instead of the plan best for him. If this tax cost differential is kept in mind, the parties will be reaching their agreement on price on an informed basis and not be surprised later to learn of a hidden tax which, if realized earlier, would have caused one party to refuse to accept the transaction. If counsel reviews these many possibilities, and brings the difference in tax cost to his client's attention, he has surely served his client well.

<sup>79</sup> INT. REV. CODE OF 1954, § 382(b)(1).

<sup>80</sup> INT. REV. CODE OF 1954, § 269.